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CHARLES ELMORE CR

In the
Supreme Court of the United States

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OCTOBER TERM, 1951

No. 383

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DOUGLAS HOTEL COMPANY, a Corporation,
PETITIONER,

vs.

COMMISSIONER OF INTERNAL REVENUE,
RESPONDENT.

—o—

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

—o—

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To: The Honorable the Supreme Court of the United States:

The petition of the Douglas Hotel Company, a corporation, of Omaha, Nebraska, respectfully prays for a writ of certiorari to the United States Court of Appeals

for the Eighth Circuit to review the decision of that court rendered July 25, 1951 (R. 124-141), reported in 190 F2d 766, which affirmed a decision of the United States Tax Court filed August 10, 1950 (R. 84-96), and reported in 14 TC 128, relating to federal taxation. The subject matter of the case is deficiencies in petitioner's excess profits taxes for the years 1942 and 1943. A final decision for those two years will result in a determination of the same taxable status of petitioner for the years 1944 and 1945. The total amount involved for the four years is $34,034.51, plus statutory interest at six cent. The Excess Profits Tax Act under which the deficiencies in question are alleged to have arisen was repealed, effective for the year 1946 (59 Stat. 556, 568). Congress, however, has re-enacted an Excess Profits Tax Act effective for 1950, and subsequent years varying only in the percentage of excess profits to be paid the government. The new Act is now in force and effect (Public Law 909, approved January 3, 1951. Title 26 U. S. C. A., Subchapter A, Part 40. Invested Capital Credit, Sec. 437). The decision of this Court, should the petition for this writ be granted, will concern all corporations subject to an excess profits tax which adopt the equity invested capital basis for determining the amount that shall be paid in excess profits taxes each year. Consequently the questions to be decided will be of general application in the administration of past and current excess profits taxation.

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JURISDICTION

Statutory Authority

The Court has jurisdiction to review said decisions relating to federal taxation under Section 240, Judicial Code as amended by the Act of February 13, 1925 [28 U. S. C. A. § 1254(1)].

Statutes Involved

26 U. S. C. A., Sec. 718 Equity Invested Capital (R. 129, copied in footnote 1).

(a) Definition.

(1) Money paid in.

(2) Property paid in.

(b) Reduction in Equity Invested Capital (R. 134, copied in footnote 6).

(1) Distributions in previous years.

(2) Distributions during the year.

Sec. 113. Adjusted Basis for Determining Gain or Loss (R. 129, copied in footnote 2).

(a) Basis (Unadjusted) of Property.

(4) Gift or transfer in trust before January 1, 1921 (R. 131, copied in footnote 4).

Regulation 111.

Sec. 29.115-6. Distributions From Depletion Or Depreciation Reserves (R. 135, copied in footnote 7).

Regulation 112.

Sec. 35.718-1. Determination of Daily Equity Invested Capital—Money and Property Paid in (R. 129, copied in footnote 3).

The Opinion Below

The decision of the United States Court of Appeals for the Eighth Circuit was rendered July 25, 1951 (R. 124-141), reported in 190 F2d 766, which affirmed a decision of the United States Tax Court filed August 10, 1950 (R. 84-96), reported in 14 TC 128, relating to federal taxation.

SUMMARY AND SHORT STATEMENT OF THE MATTERS INVOLVED

1. The Articles of Incorporation of the petitioner were signed and filed in Nebraska on January 2, 1913 (Ex. 39, R. XVI). The Nebraska law in force in 1913 and at all times since (now RSN 1943, Sec. 21-128) stated that a corporation might pay for property with its capital stock, and "in the absence of actual fraud in the transaction, the judgment of the directors, as to the value of such labor, property, real estate or leases thereof, shall be conclusive." (R. 47.) The Articles of Incorporation of petitioner stated, "The Corporation is organized to build, maintain and operate a first-class, fireproof hotel in the City of Omaha. To that end it shall have power and authority to acquire, own and hold Lots 7 and 8 in Block 109 in the City of Omaha, Douglas County, Nebraska, and such other and further real estate as may be necessary for corporate use." The Articles further provided, "Two Hundred Thousand Dollars of the common stock shall be issued to represent the value of the hotel site donated to the Corporation, and it shall be distributed and donated with $400,000 of the preferred stock first subscribed, one share of common stock being given with two shares of preferred stock." (Ex. 39, R. 55, 56.)

2. Arthur D. Brandeis owned these two lots and adjoining lots in 1913, having acquired them in November, 1912. In December of 1912 he made a proposal to a group of financiers in Omaha that if they would incorporate a company for the purpose of erecting a 16-story first-class hotel and obtain a financially responsible lessee operator, and if the corporation would procure $400,000 cash from the sale of preferred stock, he in turn would transfer these lots to the corporation in exchange for $200,000 of par value common stock which the corporation must issue as an inducement for the quick sale of the preferred stock. This agreement was a part of the financial program for raising the necessary capital. The corporation was accordingly organized and incorporated, with the above empowering provisions set forth in its articles, in order to meet the Brandeis conditions for the conveyance above set forth (All Exhibits are epitomized in the Record index pages vi to xxviii).

3. On January 6, 1913, Arthur D. Brandeis and his wife executed the deed to the two lots and placed it in escrow with their attorney, John L. Kennedy. The oficers and directors of the corporation proceeded to fulfill the conditions imposed by the grantor for the transfer (R. 56 to 61, Pars. 8 to 26). The deed was withheld during the months of January and February and up to March 11, 1913, when at a meeting of the Board of Directors of petitioner, then duly recorded, it was announced that all the preferred stock had been subscribed to the full extent of $400,000; that each preferred stockholder had been issued the common stock as fully paid by the exchange for the site; and that a responsible corporate lessee tenant had been obtained with $200,000

paid-in capital stock, which was sufficient to furnish, equip, run, and operate the hotel (Exs. 8, 9, 10, 11, 12, R. vii to x). The income to petitioner was thus fixed with a net rental of $70,200 per year, payable monthly for twenty years (R. 57, par. 14). The tenant was also required to pay, in addition, all expense of upkeep, taxes (except petitioner's federal taxes), and all necessary repairs and replacements, and to run and operate the hotel in the first-class manner required by Mr. Brandeis, the grantor. Also, the plans and specifications for the construction were presented by the architect at said March 11, 1913, meeting, and accepted by petitioner. The estimated cost of the construction of the hotel was approximately $900,000. At said time the architect was employed to proceed, and the building contract was approved. A brokerage fee of $12,000 was paid to one who had been employed to obtain for petitioner the twenty-year lease at $70,200 per year net. The same corporate lessee is still operating the property, now at $80,000 per year rental (R. 58, Par. 15, Ex. 11, Index viii to x).

4. All these conditions were fulfilled and were no longer speculative. The conditions precedent as fulfilled were manifested by the evidence recorded in the minutes of the petitioner and in the record as above indexed (Index to R. vii to xv, Exs. 9 to 36). Consequently, the deed was delivered to petitioner on March 11, 1913, and recorded on that day (Ex. 12, R. ix; R. 58, Par. 15).

5. The following month it developed that an additional 22 feet of land were required (R. 58, Par. 16). This land was also obtained from Mr. Brandeis upon the same terms and conditions as Lots 7 and 8 (Ex. 37, R.

xv). The corporation assumed, however, $15,000 of mortgage indebtedness against the 22 feet and $1,386.08 in special assessment taxes.

7. The corporation then sold $94,550 additional preferred stock for cash, and petitioner was required by Mr. Brandeis to issue $46,275 par value of common stock in exchange for the 22 feet additional. This was done to enable Mr. Brandeis to sell the $94,550 of additional preferred stock, which he agreed to do. This was accomplished, and the transactions approved by the Board of Directors (Ex. 24, R. xiii), the stockholders, and Mr. Brandeis previously in April, 1913. The 22 feet were then deeded to petitioner (Exs. 13, 15, R. x, xi; R. 58, Par. 16).

8. Thus, the total outstanding preferred stock was $494,550 paid for in cash, and $246,275 in common stock paid for by the two conveyances of the site. The dimensions of the property were 154′ by 154′, and the property is located on the northwest corner of 18th and Douglas Streets in the downtown business section of the City of Omaha, Nebraska. The property was and is known as "Hotel Fontenelle." (R. 59, Par. 19.)

9. The corporation had no indebtedness of any nature at the outset. Its capital stock liability was $740,825 for issued and outstanding stock. Thus the corporation balance sheet disclosed cash assets of $494,550 and land assets of $246,275, or a total of $740,825, against which it had issued $494,550 of preferred stock and $246,275 of common stock as fully paid and nonassessable, and so approved by the directors (R. 61, Pars. 25-6). No change or alteration by decrease or appreciation has been made in this capital stock structure of petitioner any time since the stock was issued in 1913 (R. 69, Par. 48).

10. Before the deed was released from escrow on March 11, 1913, the petitioner had agreed to borrow $444,000 as a part of the financing program to assure the construction and to obtain the deed from Mr. Brandeis. Thus it will be seen that the corporation had available $494,550 in cash from the preferred stock and $444,000 in cash from the mortgage. The corporation promptly proceeded to build the 16-story hotel. It cost $929,841.86. The hotel was completed for occupancy, and rental began on March 1, 1915, under the lease executed March 11, 1913 (R. 60, Pars. 21-3).

11. The rents, in accordance with the lease with the corporate tenant, amounted to $54,212.08 in 1915. Rent began on March 1, 1915. From that date to December 31, 1923, the rental earnings amounted to $614,012.08 which, after expenses were paid, was distributed to the stockholders, or their assignees, who had both common and preferred stock issued to them in 1913.

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12. On January 1, 1924, all the stock of the original subscribers was purchased from them by Rome Miller for $1,100,000. The building was then encumbered for about $300,000. A new lease with the same tenant became effective January 1, 1924, for thirty years at $80,000 per year net, which lease is still in force and effect. Dividends of $29,773.80 were paid for the year 1915, the year the hotel opened. Total dividends paid up to and including 1948 were $620,565.23. Generally the dividends have been approximately $30,000 per year from the outset and distributed over $740,825 par value of stock (R. 60-1, Pars. 21 to 26).

13. The mortgage indebtedness was reduced in accordance with the mortgage from $444,000 to $201,000 at the close of the year 1948 (R. 61, Par. 24). The corporation had set up on its books as the actual cost of the building, $929,841.86, and the actual cost to the corporation of its real estate, $246,275, plus $15,000 mortgage and $1,386.08 for special improvement taxes on the real estate, assumed and paid by petitioner. This has been the status of the corporation's financial statement from the beginning in 1913-14, and there has been no change or alteration therein. There has been no sale of any corporate asset, and as above stated, no reduction and no appreciation of the petitioner's original investment. The accounting is simple, and the few figures readily understandable (R. 61, Par. 26; Exs. 30 to 35, R. xiv to xv).

14. During all this period the corporation has paid its normal and surtax federal income taxes. Rome Miller and the members of his family became the sole stockholders, except for qualifying shares for directors, on January 1, 1924. The corporation's fixed annual liabilities were $10,000 principal payment on its mortgage indebtedness and the accruing interest at five per cent on the unpaid balance, some moderate officers' salaries, accounting fees, and an occasional attorney fee. The petitioner's sole earnings were the fixed rental above set forth (R. 67, Par. 45).

15. In figuring the normal income taxes (before the Excess Profits Tax Law in 1940) the corporation arrived at its net taxable income by deducting from its rental earnings the ordinary expenses and interest paid on its mortgage indebtedness, and the depreciation allowed un-

der the normal income tax statute on the building which had cost $929,841.86. This depreciation was larger in 1923 and less after 1938 when reduced to $14,500 per year. This method of accounting always left cash balances on hand from the earnings on the lease. The dividends to be paid to its stockholders were readily determined, and the stockholders paid their individual income taxes thereon. Before the dividends were paid, however, or any payments made from the cash on hand to stockholders, the principal of the mortgage indebtedness of $10,000 per year and all current expenses were paid. The balance of cash on hand derived from the lease as earnings was paid to the stockholders over the years from 1924 to 1948 (R. 72-3, Pars. 59 to 63; R. 74, Par. 69).

16. No question has been raised in the case as to the correctness of any of the foregoing figures. All were shown on the books and records of the corporation. No accounting problems are involved. The amount of reserve for depreciation from 1923 to 1940 shown on the books of the corporation, deducted to reduce the normal income tax paid by the corporation, was $448,438.67 (R. 70-1, Pars. 50 to 56). No distinction was made by the corporation in its cash balances in its bank account. No income taxes were paid by the shareholders (Rome Miller and family) on the cash retained by the corporation and paid to shareholders as a result of deductions for depreciation. The stockholders, however, under the law and decisions, must account for all such money received upon sale of the stock, because the payment from depreciation, though paid from the gross earnings, reduces the cost of the stock to the stockholder and thus increases the capital gain tax which the stockholder must pay when he dis-

poses of his stock. It is not the corporation's concern if reserve for depreciation is paid to stockholders so long as the cash is unnecessary for corporate purposes.

17. The Excess Profits Tax Law affecting this corporation and for the purpose of this suit became operative for the calendar years 1942, '43, '44, and '45. The corporation filed its returns showing no excess profits tax due and returned its invested capital for the amounts above set forth, including real estate at $246,275 plus $16,386.08 liens paid as part of the purchase price of the real estate site (R. 61, Pars. 24-6).

18. In the examination of the returns the Commissioner struck from equity invested capital all petitioner's real estate investment (even including the $15,000 and the $1,386.08 assumed and paid in liens against the real estate site), claiming the land was transferred as a gift to the corporation from Arthur D. Brandeis and therefore was ineligible for equity invested capital (R. 30, Pars. 6-8). To arrive at net taxable income for normal tax purposes the Commissioner deducted the $448,438.67 paid to Rome Miller and family as stockholders from the cash remaining from the lease earnings, resulting from the deduction for depreciation previously made. The Commissioner alleged this money constituted a withdrawal of capital, and by payment to the stockholders constituted a reduction in the original invested capital of the corporation by said amount of $448,438.67 (R. 19, Resp. Ex. C, balance sheets—last line). These two deductions from equity invested capital resulted in the deficiencies in excess profits taxes for said four years amounting to $34,-034.51 and interest. Only the two years 1942 and 1943 are before the Court, but a final decision in this case will

govern also the years 1944 and 1945. The law applicable is the same for all four years. Furthermore, all corporations in the United States which pay excess profits taxes on the invested capital basis will necessarily be affected by the final decision of this Court if certiorari is granted.

19. At the trial before the Tax Court the Commissioner denied the right to include the real estate site or stock issued therefor as equity invested capital, claiming the site was a gift to the corporation. The petitioner contended that it was not a gift because the corporation as such was required to issue $246,275 in common stock for the site. Also, when the conditions precedent to delivery of the deed from Mr. Brandeis were fulfilled at the time the deed was released from escrow on March 11, 1913 (Exs. 11 and 12, R. viii-ix), the site had an actual valuation equal to the par value of the stock of $246,275 (R. 62-3, Par. 29; R. 64, Par. 36; R. 81, Par. 87; R. 82, 90; Exs. "C", "D", "E", "F", "G", R. xx to xxiii). The Tax Court denied this method for valuation, and instead adopted cost to Mr. Brandeis in November, 1912. The Court of Appeals affirmed. Petitioner claims reversible error of law, as there was ample competent, clear, convincing evidence to sustain petitioner's method for $246,275 valuation on March 11, 1913, when the deed was delivered after conditions precedent were fulfilled as shown by the testimony of all witnesses including those of the respondent (cf. last above, record references).

20. The Commissioner followed the ruling of the Eighth Circuit in *Brown Shoe Co. v. Commissioner,* 175 F. 2d 305. Before the decision of the Tax Court was rendered herein, the Brown Shoe Co. case was reversed by the Supreme Court of the United States (339 U. S. 583, 70

S. Ct. 820), which held that even though property were a gift to a corporation, it was a contribution to capital under the revenue statute, and therefore was entitled to be listed as invested capital but on the basis of cost to the transferor.

21. In the case at bar the transfer was made prior to January 1, 1921, and obviously was not a gift, because consideration passing from Petitioner was issued for the land. Consequently, the cost to the petitioner at the time of delivery of the deed on March 11, 1913, must govern as a matter of law.

22. The Tax Court fixed the valuation of the land at $125,000 based upon cost to the "donor" in November, 1912, stating it was a gift to petitioner. The Court of Appeals for the Eighth Circuit adopted the Tax Court's view and held that it was a matter of valuation which was peculiarly the right of the Commissioner and the Tax Court to determine on any fair basis they might derive from the evidence. Petitioner contended there was an error in the application of the law, as to both the method used and the time for valuation of the stock. The real estate was conveyed to petitioner in exchange for its stock, irrespective of who became the holder of the stock, whether Mr. Brandeis or others.

23. In reference to the depreciation deduction to reduce the equity invested capital, the petitioner contended before the Tax Court and before the United States Court of Appeals that no authority existed in the Excess Profits Tax Statutes for the reduction of equity invested capital if stockholders were paid from earnings that re-

mained on hand due to the deduction for depreciation to arrive at net taxable income for the purpose of the normal income tax. The Tax Court was affirmed by the Eighth Circuit in holding that even though there was no express statutory authority for such deduction, it did constitute a distribution other than from earnings or profits. The Eighth Circuit created new law in so doing, and error is predicated thereon.

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24. The petitioner is a holding corporation, and in accordance with the interpretation of the term "engaged in business" as used in the past, the petitioner was not engaged in business (R. 64, Par. 37). Accordingly, petitioner raised the issue in the Tax Court and in the Eighth Circuit that it was exempt under Sec. 727(g)(2) of the Excess Profits Tax Act. The petitioner waives that point in this petition for writ of certiorari. The fact remains that the taxpayer has no control over its income so far as the purpose of an Excess Profits Tax Act is concerned. Its annual income was fixed in 1923 for thirty years, and the only business in which it was engaged was the collection of the rent as its earnings, from which all items must be paid, including payments in cash to stockholders from cash earnings remaining on hand. However, Congress failed to make the language sufficiently clear to exempt the petitioner under Sec. 727(g)(2), and both the Tax Court and the Eighth Circuit so held. Therefore that point will not be urged further in these proceedings for the petition for the writ or before the Court in the event the writ is granted.

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QUESTIONS PRESENTED

I.

Re: The Transfer of Land

1. Did the court below commit reversible error when it upheld the Tax Court in deciding that the transfer of the land to the petitioner was a gift, when the undisputed evidence is that the conditions imposed by the grantor were that the petitioner corporation, as such, issue $246,275 par value of common stock in exchange for the land?

2. Did the court below commit reversible error when it refused to accept clear, convincing, and competent evidence of the value of the land based upon the fulfilled conditions precedent prior to the delivery of the deed to the land on March 11, 1913?

3. Did the court below commit reversible error in holding that the Tax Court and the Commissioner were the sole judges in determining the land valuation based upon cost to the transferor in November, 1912, when as a matter of law the cost to the transferee at the time of acquisition on March 11, 1913 was the proper measure for the valuation?

4. Did the court below commit reversible error by accepting the sum of $125,000 for equity invested capital, when the evidence of cost of the land to the transferor was approximately $125,000 in November, 1912, and the evidence of cost to the transferee was at least $246,275 when the conditions precedent were fulfilled at the time of acquisition on March 11, 1913?

5. Did the court below commit reversible error when it held, contrary to the clear, competent, and convincing evidence, that the construction of the hotel, its financing, and its rental income were speculative rather than real, and accordingly rejected the value of the stock issued in exchange for the land based upon these realities?

6. Did the court below commit reversible error by holding that the date of the deed, January 6, 1913, and the date of the delivery thereof, March 11, 1913, were both immaterial but that the date of November, 1912, was material, when during said period prior to delivery the conditions precedent for delivery were all fulfilled and there was competent, clear, and convincing evidence of the soundness and correctness of the value set up on the books of petitioner at said time as the cost to the transferee on the date of acquisition?

7. Did the court below commit reversible error, even assuming that the transfer of the land was a gift to the corporation, in failing to apply the statutory mandate (Sec. 113a4) in reference to the acquisition of gifts of land prior to January 1, 1921, wherein it is provided that the fair market value at the time of acquisition (March 11, 1913) by the transferee shall govern rather than the cost (November, 1912) to the transferor?

8. Did the court below commit reversible error when it stated:

> "We are only called upon to say whether there was substantial evidence to support the findings of the Tax Court. Being supported by substantial evidence, we are not at liberty to set aside the findings of the Tax Court of the fair market value of the real estate,"

when it appears that the Tax Court created its own rules of law to arrive at its conclusion that the cost to the grantor, Mr. Brandeis, in November of 1912 was the "substantial evidence" to which the Court of Appeals referred in affirming the Tax Court's decision?

II.

Re: Depreciation

9. Did the court below commit reversible error when it permitted $448,438.67 to be deducted from the equity invested capital of the petitioner, which amount had been paid by the corporation to its stockholders over the years from 1923 to 1940 from its cash balances remaining after the payment of dividends, mortgage retirement, interest, and other expenses, it appearing that such cash balances were the result of the deduction for depreciation upon the hotel building to arrive at net taxable income for the normal income tax purposes?

10. Did the court below commit reversible error when it concluded that the payment to the stockholders over the years 1923 to 1940 was a reduction of the invested capital and was a payment made "not out of earnings and profits," it appearing that the actual money itself so paid necessarily came from earnings, i. e., income from rent?

11. Did the court below commit reversible error in affirming the reduction of equity invested capital by $448,438.67, when nowhere in the entire Excess Profits Tax Act applicable and in none of the Regulations and in no decisions of any court up to this time is there authority for the reduction of equity invested capital be-

cause of the payment to stockholders by the corporation of its cash balances, including cash reserve attributable to depreciation for income tax purposes?

12. Did the court below commit reversible error in permitting the creation of new law in reference to excess profits taxes by holding that the withdrawal of the reserve for depreciation obliterated equity invested capital, when the obvious intent of the statutory equity invested capital method is to grant to the excess profits taxpayer the right to continuous benefit of the original equity invested capital, irrespective of obsolescence, depreciation, dilapidation, or depletion of the property represented as equity investment, unless there is a sale and distribution of the proceeds of sale of such properties that go to make up equity invested capital?

13. Did the court below commit reversible error when it failed to recognize that the only result permitted in the law of the withdrawal of depreciation and the payment of the same to the stockholders by a corporation, is the reduction of the cost of the shares of the capital stock to the shareholder? Thus is the government insured an increased capital gains tax upon the transfer or the succession of the shares of stock from the shareholder or his heirs or assigns? This is the only provision in the normal income tax law relating to the withdrawal of reserve for depreciation and the payment to shareholders.

14. Did the court below commit reversible error by affirming the Tax Court in its creation of a new rule of law to the effect that the withdrawal of reserve for depreciation constituted a reduction of equity invested cap-

ital to the extent of the withdrawal, when the term "distribution not out of accumulated earnings or profits" (Sec. 718b1) upon which the court relied had never been defined in the statute or regulations or by any court decision to include the withdrawal of reserve for depreciation?

15. Did the court below commit reversible error when it failed to reverse the Tax Court in its reduction of equity invested capital by the withdrawal of the reserve for depreciation, when Congress nowhere in the Excess Profits Tax Act or in any excess profits tax Regulation provides for such reduction of equity invested capital if the reserve for depreciation is or is not withdrawn or distributed to the stockholders?

16. Did the court below commit reversible error when it failed to recognize that the word "accumulated earnings" in the statute differs from "net earnings" and "profits," and in holding that the "distribution" to stockholders was not out of "accumulated earnings."

III.

Summary of Record, Narration of Evidence and Exhibits

17. Each of the foregoing questions will be carefully presented and briefed if this Court will grant the writ.

18. Under the new Rules of the Court of Appeals, Eighth Circuit, effective January 1, 1951, petitioner was required to narrate all the testimony given at the trial, including exhibits, and print the same in the record. Consequently, there is before this Court that record so made. Petitioner respectfully invites the Court's attention to

the record pertaining only to the questions presented above:

R. 54-61, Pars. 1-27, incl.

R. 62-66, Pars. 29, 31-37, incl.

R. 67, Par. 44; Ex. 40, R. xvi; Exs. 41-45, incl., R. xvii.

R. viii to xvi, Exs. 9-39, incl.

Exs. D to G, R. xx to xxiii, incl.

Exs. H, I, K, L, P, Q, R, S; R. xxiii to xxv, incl.

R. 67-83, Pars. 45-90, incl.

REASONS RELIED UPON FOR THE ALLOWANCE OF THE WRIT

I.

The opinion of the Eighth Circuit has departed from the accepted and usual course of judicial proceedings, and in so doing has sanctioned such departure by the Tax Court as to call for an exercise of this Court's power of supervision.

1. Neither the Tax Court nor the Court of Appeals was confronted with a conflict in the evidence on the valuation of real estate transferred to a corporation. The point involved is whether the court below erred when it sanctioned the Tax Court's determination that the value of the real estate involved should be measured by the price paid for it by the grantor, Arthur D. Brandeis, in November of 1912, or whether it should be measured at cost to the petitioner at the date of its acquisition, March 11, 1913.

2. It is apparent from the references to the record set forth on page 20, supra, of this petition that the cost to the grantor in November of 1912 was approximately $125,000 (plus $16,386.08 of liens assumed and paid by the grantor), as opposed to $246,275 which was the cost to the grantee when the applicable federal tax statutes and the regulations are applied. It therefore is a question of law and not one of fact.

3. Likewise, it is a matter of law that the transfer from Mr. Brandeis to the corporation was not a gift or a donation with nothing passing from the petitioner therefor, but it was a transfer of land to the corporation for which the corporation issued $246,275 par value of its common stock in exchange therefor, and when so issued was and is an outstanding liability of the Petitioner for the full amount.

4. Consequently, when the Tax Court held that the property transferred should be treated as a gift on the basis of *Brown Shoe Co., Inc. v. Commissioner,* 339 U. S. 583, 70 S. Ct. 820, the conflict is apparent. In the *Brown Shoe Co.* case there can be no doubt that the property was a gift as a contribution to capital, while in the case at bar the corporation paid for the land in capital stock to the extent of $246,275, therefore the applicable law differs.

5. There is no conflict in the evidence that stock to the par value of $246,275 was issued by the corporation for the land and that this was the arrangement made between the corporation and the grantor. Under such circumstances, there can be no gift because the definition of a gift embodies no consideration passing to the donor

from the donee. Consequently, the writ of certiorari should be granted in order that this Court might correctly adjudicate the legal proposition that March 11, 1913, the date of the delivery of the deed which was placed in escrow, was material on the question of valuation at that time, and likewise that this Court might apply the provisions of the federal statute and Regulations in reference to determining the valuation of the land and the stock, or both, in arriving at fair valuation. The figures and amounts are not in dispute if the legal problems as to the dates are decided as contended by the petitioner.

6. Internal Revenue Code Sec. 718, Equity Invested Capital, subsection (a)(2), states:

> "Property paid in. Property (other than money) previously paid in (regardless of the time paid in) for stock, or as paid-in surplus, or as a contribution to capital. Such property shall be included in an amount equal to its basis (unadjusted) for determining loss upon sale or exchange. * * * ."

7. Regulation 112, Sec. 35.718-1, states:

> "If the basis to the taxpayer is cost and stock was issued for the property, the cost is the fair market value of such stock at the time of its issuance. If the stock had no established market value at the time of the exchange, the fair market value of the assets of the company at that time should be determined and the liabilities deducted. The resulting net worth will be deemed to represent the total value of the outstanding stock. In determining net worth for the purpose of fixing the fair market value of the stock at the time of the exchange, the property paid in for such stock shall be included in the assets at its fair market value at that time."

8. Regulation 108, Sec. 86.19(c), states:

> "If actual sales or bona-fide bid and asked prices are not available, then, in the case of corporate or other bonds, the value is to be arrived at by giving consideration to the soundness of the security, the interest yield, the date of maturity, and other relevant factors, and, in the case of shares of stock, upon the basis of the company's net worth, earning power, dividend-paying capacity, and all other relevant factors having a bearing upon the value of the stock. Complete financial and other data upon which the donor bases his valuation should be submitted with the return."

9. By reference to the "Narration Of The Evidence," and the exhibits with the record references collected on page 20, supra, of this petition, and as further explained with record references in the Summary and Short Statement of the Matters Involved on pages 4-14, incl., supra, it should be concluded that there is no conflict in the fact that the stock did have a valuation of at least $246,275 and that it was so considered by the Board of Directors of the corporation, by the transferor Brandeis, by all interested parties, and by each witness in the case, both those for the petitioner and those for the respondent, as will be seen from the foregoing citations.

10. However, the court below saw fit in its opinion to condemn the testimony of the witnesses for the respondent and the petitioner. The court stated that even though there were a written lease upon the property guaranteeing for a period of twenty years a rental of $70,200 for a 16-story hotel building to cost approximately $1,000,000, and land at approximately $250,000, no authority existed for evaluating the land on the basis

of the capitalization of the contracted income. The court below held, in reference to the capitalization of income to determine valuation, as follows:

> "But no authorities are cited and we know of none which support petitioner's theory that the triers of the fact should be required to accept petitioner's estimate of the proportionate value the real estate would have of the value of the entire property when completed, and then to further accept as fair market value of the real estate a figure representing the capitalization, on a percentage basis, of that portion of the total expected income hypothetically allocated by petitioner or its witness as the annual rental from the real estate alone."

This holding is contrary to the suggestions made by this Court in *Kimball Laundry Co. v. U. S.* (1949), 338 U. S. 1, 69 S. Ct. 1434, wherein the Court said:

> Page 1443, footnote 7. "* * * The alleged value was about $650,000, and the average annual earnings $39,375.39, a return on that value of about 6%. On the other hand, the Government's own expert witnesses respectively valued the physical property, after allowing depreciation, at $455,000 and $433,500, and on that basis the rate of return would be about 9%. It is not for us, at any rate, to assume that 6% rather than 5% or some lower figure is the lowest that would compensate investment in the physical property.
>
> "The importance of varying in accordance with varying risks the percentage at which income is capitalized to obtain business value has been emphasized by the Securities Exchange Commission in computing value for purposes of § 77 B reorganizations. [11 U. S. C. A. § 207] See Note, 55 Harv. L. Rev. 125, 133 (1941). See also Fisher, The Nature of Capital and Income, c. 16, 'The Risk Element' (1906); Angell, Valuation Problems 14 (Practicing Law Institute, 1945)."

11. The opinion also cites 1 Bonbright, The Valuation of Property cc. 11, 12 (1937); 1 Dewing, Financial Policy of Corporations, bk. II, c. 1 (4th ed., 1941); and refers to *Consolidated Rock Products Co. v. DuBois,* 312 U. S. 510, 525-526, 61 S. Ct. 675, 684-685, 85 L. Ed. 982, and *Group of Institutional Investors v. Chicago, M., St. P. & P. R. Co.,* 318 U. S. 523, 540-542, 63 S. Ct. 727, 738-739, 87 L. Ed. 959. These citations do not begin to exhaust the subject of determining valuation based upon rental income. In the case at bar the income was fixed and determined under the lease for twenty years at $70,200 per year. We know the cost of the building, and we know the amount of capital stock that was issued in exchange for the site. We know from the evidence that there is no dispute between any of the witnesses that the executed lease upon that property and hotel, fully financed, resulted in the land having a valuation of $246,275 (R. 62, Par. 29; 64, Par. 36; 81, Par. 87; 82, Par. 90).

12. The three witnesses, the only ones to testify in the case on the question of the value of the site capitalized on the basis of earnings under the executed lease for twenty years, were each exceedingly competent and disinterested. The last two were the respondent's witnesses. Also the expressions found in the respondent's evidence of the statements taken from prominent businessmen in Omaha at said time as to the valuation of the site on March 11, 1913, are collected as Exhibits C, D, E, F, and G (R. xx-xxiii). Each of these newspaper articles introduced by the respondent and accepted in evidence was admitted by the witness Mr. Reed to have been statements made by the men quoted in the newspapers (R. 64, Pars. 32, 33).

13. When a deed, previously dated, is held in escrow, the actual date of delivery becomes a question of law and not of fact. The court below treated the matter as a question of fact and affirmed the Tax Court in saying that neither the date of the deed, January 6, 1913, nor the date of its delivery, March 11, 1913, was material, even though the conditions precedent imposed by the grantor had been fulfilled between said dates to the satisfaction of the grantor as shown by Exhibit 12, the minutes of the stockholders meeting on March 11, 1913, and the minutes immediately preceding and following. *Lewis v. Marker,* 145 Neb. 763, 18 N. W. 2d 210, syl. 4; *William A. Ehlers v. Martha Seip,* 136 Neb. 722, 287 N. W. 202, syl. 4; Thompson on Real Property (Perm. Ed.), Vol. 7, §§ 4110, 4118.

14. The decision of the Supreme Court in *Commissioner v. Culbertson* (1949), 337 U. S. 723, 743-5, 67 S. Ct. 1210, 1214-15, paragraph 8, syl. 10, announced the law that the Tax Court may not substitute its own judgment for that of the parties. Obviously the Tax Court and the Commissioner are bound under the rules of law to keep within the confines of the statute, the Regulations, and generally the law of the land in arriving at federal tax determinations.

15. In the case at bar the Court has seen, from the evidence referred to and the references above, the cost of the real estate, the cost of the building, the mortgage thereon, and the payments thereon. From this equity invested capital there has never been a reduction or disposition by sale or liquidation, as is frequently the case. Nevertheless, the Tax Court was upheld by the court be-

low in deducting $125,000 from real estate valuation and $448,438.67 from equity invested capital because of payments to the stockholders from accumulated earnings. As repeatedly above stated, the Commissioner did so even though in the accounting system permitted by law to arrive at net taxable normal income, the cash paid out was the result of the deductions for depreciation.

16. Therefore, the total deductions from equity invested capital claimed by the Commissioner were $573,438.67. Petitioner requests the opportunity to have the law corrected by this Court to conform to the Revenue Code and the generally accepted legal concepts found in the decisions.

II.

Herein the Court of Appeals, Eighth Circuit, has decided an important question of federal law which, as yet, has not been but should be settled by this Court.

1. The important question erroneously decided has resulted in the following law that should be changed: That henceforth, a corporation subject to the excess profits tax which adopts the equity invested capital basis must annually reduce its original investment, if such corporation has no need for its accumulated earnings, which include cash on hand from reserve for depreciation derived in arriving at net taxable income, and pay it to its stockholders.

2. The petitioner is in that predicament and must pay alleged tax deficiencies of $34,034.51, plus six per cent interest, because it elected to pay its accumulated earnings to its stockholders.

3. The petitioner might have used the accumulation as working capital, thus increasing its invested capital to that extent. Or it might have invested it in additions or improvements or purchased new assets to be used in the business, and thus increased its investment. But petitioner had no such needs. Its earnings were its fixed annual rental. The tenant paid for repairs and upkeep.

4. The Excess Profits Tax Act in no part provides for the reduction of equity invested capital by the amount of the payment from accumulated earnings due to the deduction for depreciation from gross earnings to arrive at net taxable income.

5. Regulation 112, Sec. 35.718-1 reads as follows:

> "The fact that the money or property paid in has been lost, destroyed, or otherwise disposed of shall not reduce the invested capital except as such facts are reflected in the earnings and profits as of the beginning of the taxable year."

6. Furthermore, Regulation 112, Sec. 35.718-2 states:

> "Determination of Daily Equity Invested Capital Accumulated Earnings and Profits.—(a) In General.—The term 'accumulated earnings and profits' is not defined in the Internal Revenue Code * * *."

7. Regulation 112, Sec. 35.718-5 states:

> "Depreciation of daily equity invested capital—reductions by distributions.—The amount of the daily equity invested capital as partially determined by taking the aggregate of the sums described in section 718(a) shall be reduced by the amount of the distributions made in prior taxable years which were not out of accumulated earnings and profits plus the amount of the distributions previously made during the taxable year which were not out of the earnings

or profits of such year. In determining whether a distribution is out of the earnings and profits of any taxable year, such earnings and profits shall be computed as of the close of such taxable year without diminution by reason of any distribution made during such taxable year or by reason of the excess profits tax imposed by the Excess Profits Tax Act of 1940, or by reason of the tax imposed by Chapter 1, and without regard to the amount of earnings and profits at the time the distribution was made."

8. It will be noted that the Regulation makes no statement that reserve for depreciation is eliminated from "accumulated earnings." The National Congress was charged with the responsibility of expressing such deduction of equity invested capital if it were the intention that accumulated earnings were not to include reserve for depreciation. It would have been a simple matter to have made such statement, had that been the intention of the lawmakers.

9. The federal statute, which does provide how equity invested capital may be reduced, states only that it shall be reduced by "distributions made prior to such taxable year which were not out of accumulated earnings and profits." (I. R. C., Sec. 718(b)(1).)

10. Furthermore, the statute defines what shall be a distribution to shareholders that will reduce equity invested capital "not out of accumulated earnings and profits." I. R. C., Sec. 718(c)(1),—Distribution to Shareholders:

> "The term 'distribution' means a distribution by a corporation to its shareholders, and the term 'distribution in stock' means a distribution by a corporation of its stock or rights to acquire its stock. To the extent that a distribution in stock is not considered

a distribution of earnings and profits, it shall not be considered a distribution. A distribution in stock shall not be regarded as money or property paid in for stock, or as paid-in surplus, or a contribution to capital."

Sec. 718(c)(3). "Computation of earnings and profits of taxable year. For the purposes of subsections (a)(3)(b) and (b)(2) in determining whether a distribution is out of earnings and profits of any taxable year, such earnings and profits shall be computed as of the close of such taxable year without diminution by reason of any distribution made during such taxable year or by reason of the tax under this subchapter or chapter 1 for such year and the determination shall be made without regard to the amount of earnings and profits at the time the distribution was made."

11. Here, again, the Congress had ample opportunity to express itself, had it desired to do so, and to insert that a distribution to stockholders of a reserve for depreciation would reduce equity invested capital. This the Congress did not do.

12. The court below cited *Detroit Edison Co. v. C. I. R.* (1943), 319 U. S. 98, 101, 63 S. Ct. 902, to sustain its decision that distributed reserve for depreciation reduced equity invested capital for excess profits tax purposes. The Edison case had nothing to do with excess profits taxes. It merely defined depreciation and was cited by the petitioner herein in the court below because of the excellent definition of depreciation contained in the opinion. Instead, the court below sought to liken for excess profits tax purposes the whittling of a lead pencil as depreciation, which in the end would leave no lead pencil. But such is not the effect if depreciation is

withdrawn from accumulated earnings. Equity invested capital remains the same unless the items that make it up are sold or liquidated and paid to stockholders.

13. In *Guantanamo Sugar Co. v. Helvering* (1936, CA DC), 85 F. 2d 252, 255, pars. 3 and 4, the court said:

> "The effect of all these decisions is that the original investment in a corporation, for the purpose of computing the excess profits tax, remains the same. Subsequent depreciation no more reduces than subsequent appreciation augments the amount. In this view, it is apparent that the value of the shares of stock of the Railroad Company acquired by the petitioner at the time of its organization continues as a part of its invested capital, and this is nonetheless true because of the action of the directors for company purposes in writing down the value of the item."

14. In that case the Court of Appeals permitted an original investment of $422,250 to remain as fixed invested capital. The opinion is quite near to the petitioner's contentions in the case at bar.

15. In *Associated Electric Co. v. U. S.* (U. S. Ct. Cl., 1951), 97 F. Supp. 821, the Court of Claims was confronted with what items constituted surplus under Sec. 201, IRC. In seeking to find a definition the court was required to distinguish between "earnings" realized at the end of an accounting period resulting in "profits," "earnings" which took in all the income of the corporation, and "net earnings" as constituting "profit" from operations. It is clear from the case that the term, "accumulated earnings," as used in the Excess Profits Tax Act, had no direct relationship to net earnings or profits. Consequently, any money that was in the till of the corporation constituted accumulated earnings if from that source.

16. If, in the case at bar, in petitioner's accounting system used to arrive at net taxable income, those earnings were reduced by expenses and allowable deductions for depreciation, then what was left came from accumulated earnings and from no other source, because the corporation had no earnings except its fixed lease income. Admittedly the accumulated earnings did not arise from the sale of assets, thus becoming income from an outside source. This same result would apply to all corporations paying excess profits taxes based on equity invested capital, if they had "earnings."

17. Thus, it seems apparent to petitioner that this is an important question that should be settled by the Supreme Court of the United States.

18. Furthermore, it would seem that the decision of the Eighth Circuit is in conflict with *Guantanamo Sugar Co.*, supra, a District of Columbia Court of Appeals decision.

19. The decision below is also in conflict with the federal statute and the Regulations pertaining to the normal income taxes. These statutes and Regulations specifically provide that if reserve for depreciation is paid to the stockholders, the effect is to reduce the cost of the shares of stock in the hands of the shareholder, his heirs, successors, or assigns, and greater or less capital gains tax results, as provided in the normal income tax statutes relating to depreciation.

20. Petitioner submits that the Supreme Court should pass upon the question of whether or not excess profits taxpayers under the past and present statutes shall have their equity invested capital reduced or obliterated by the

distribution of the bookkeeping entries of reserve for depreciation and the distribution thereof to the shareholders, when neither a Regulation nor a statute exists to uphold the determination. Furthermore, it is apparent that the decision of the court below is in conflict with the other Courts of Appeals above cited. The definition of accumulated earnings should not be narrowed to exclude the cash therein from the reserve for depreciation resulting from the permissive accounting under the normal and surtax federal income tax statutes.

21. If this Court settles the question that the payment that was made herein to the stockholders was out of accumulated earnings, then such payment may not be deducted from equity invested capital for determination of excess profits taxes.

CONCLUSION

The petitioner, Douglas Hotel Company, respectfully prays that the writ of certiorari be granted for the reasons hereinabove set forth.

Respectfully submitted,

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